

**Response to Office of Management and Budget Memorandum**  
**“Loan Guarantees to Improve Federally Owned Assets”**  
**Family Farm Alliance**  
**May 2, 2008**

On April 3, 2008, Richard A. Mertens, Deputy Associate Director of the Energy, Science, and Water Branch, Office of Management and Budget (OMB), sent a memorandum to Timothy R. Petty, Deputy Assistant Secretary, Water and Science, Department of the Interior. This memo addresses the accounting treatment of certain loan guarantees that have been contemplated by the Bureau of Reclamation (Bureau) to assist water districts contracting for water from federally owned facilities in meeting their fiscal responsibilities to pay their share of the operation, maintenance, and rehabilitation of these facilities. This paper highlights the errors and misinterpretations in the OMB memo in mischaracterizing the loan guarantee program available to the Bureau and clarifies the Congressional intent of the P.L.109-451 in authorizing such activities.

**The loan guarantee function established under Title II of the Rural Water Supply Act of 2006 (P.L. 109-451) was specifically intended to fill a critical gap in federal capability.**

In general, the costs of operating, maintaining and repairing Bureau of Reclamation water storage and conveyance projects are paid by the beneficiaries of those facilities. Beneficiaries can be individuals, but mostly they are irrigation and water districts organized by landowners. The local districts receive water from Bureau facilities under contracts that require them to pay that portion of the facilities’ operations and maintenance (O&M) costs attributable to its water supply function.

In some cases, the Bureau has transferred to local water agencies the responsibility for operating and maintaining federally owned facilities, and the local agencies bill their landowners directly for costs. In other cases, the Bureau performs the O&M of a project and collects the costs from districts or individuals. When the Bureau operates a project, it generally pays the federal share of O&M costs with appropriated funds and receives the estimated non-federal share from the local districts in advance for the year. At the end of the year, the actual non-federal share of O&M costs is compared to the estimated advances from the local districts and either a credit or an invoice is provided for the difference.

Beyond the costs of day-to-day operations and normal maintenance, beneficiaries also are responsible for the costs of “extraordinary maintenance” -- major repairs and replacement of equipment. Frequently, extraordinary maintenance and rehabilitation project costs range from the millions to the tens of millions of dollars.

The Bureau of Reclamation estimates that the replacement value of its dams, canals and power facilities west wide is \$ 100 billion. Protecting the value of this huge federal asset, assuring its

safety and operational integrity, is dependent on the ability of mostly small local agencies to fund operation, maintenance and repair costs that continue to increase sharply as the Reclamation system ages. According to the Bureau, the system currently requires \$3 billion in repairs and extraordinary maintenance, the cost of which is the responsibility of both the Federal government and the landowners and local water districts dependent on these systems.

Because Federal Reclamation Law and policy requires that project beneficiaries pay the costs of major rehabilitation and repair projects in advance of expenditure, local agencies must turn to the private market to secure financing, which can be difficult because they don't own the asset they are borrowing money to repair.

In the past, the Bureau's Rehabilitation and Betterment (R&B) Program helped local districts meet these financial obligations by providing a means for spreading repayment of extraordinary maintenance and repair costs over several years. However, the R&B Program and other similar Bureau direct loan programs were abandoned by previous administrations because they were regarded as inefficient.

In 2006, Congress recognized the need to help non-federal water agencies raise non-federal dollars to pay for their share of the rehabilitation and repair of aging federal water facilities. Title II of the Rural Water Supply Act of 2006 authorized the Bureau of Reclamation to provide federal loan guarantees to Reclamation project beneficiaries to make it easier (and cheaper) for them to secure financing in the private market.

Specifically, the Act provides the Secretary of the Interior the authority to guarantee a private-sector or lender financed loan (maximum 40-year term) for up to 90 percent of the cost of an eligible project. The new Bureau program was modeled on a long-standing and highly successful loan guarantee program in the U.S. Department of Agriculture's Rural Utilities Service.

The intent of the Act was to avoid direct federal funding of the Bureau's infrastructure repair and rehabilitation needs by making it easier for project beneficiaries to fund them with private lender financing. With a small commitment of appropriations, the program could make large amounts of non-federal financing available to fund the non-federal portion of extraordinary maintenance and repairs.

The Rural Water Supply Act and its loan guarantee program were developed and enacted with the strong support of the Bureau of Reclamation. The Act instructed the Bureau to develop eligibility criteria to implement the program. However, sixteen months after passage of the Act, the program is still not in place, mainly because its implementation is being resisted by the Office of Management and Budget.

OMB's April 3 memo does not explicitly instruct the Bureau not carry out the loan guarantee program. Instead, the letter informs the Bureau that OMB will apply a "budgetary treatment" to

the program that, for all practical purposes, makes its implementation impossible. Specifically, OMB tells the Bureau that it can issue loan guarantees for major improvements and repairs, but the guarantees must be backed by an upfront appropriation equal to 100 percent, or more, of their face value. In other words, the Bureau can carry out the program, but only if it's willing to devote large portions of its already strained budget to do so.

OMB's assertion that the Federal cost of the Bureau loan guarantees should be 100 percent of the guaranteed amount contrasts sharply with the Congressional Budget Office estimate (attached) that program's cost – subsidy rate – would be only 1 to 2 percent of the amount guaranteed.

In its memo of April 3, OMB supports its argument for the 100 percent subsidy rate by misrepresenting the Bureau program as “third-party financing” and by grossly exaggerating the financial risks to the federal government while dismissing the “economic stake” that farmers and their water agencies have in the Reclamation projects upon which their livelihoods depend.

### **OMB Misinterprets the CBO Issue Brief on Third Party Financing**

In its April 3 memo to Reclamation, OMB asserts that the loan guarantees established in the Rural Water Supply Act are “third party financing” as defined by the Congressional Budget Office (CBO). The OMB memo relies upon a CBO issue brief, *Third-Party Financing of Federal Projects (2005)*, which defines third-party financing as someone other than the U.S. Treasury using private capital markets to raise money *on behalf of* (emphasis added) a federal program to be repaid on the basis of some kind of long-term federal commitment. The loan guarantee program authorized by P.L. 109-451 provides for federal loan guarantees to Reclamation's water contractors to help finance their non-federal share of the costs of major repairs, replacements, and project rehabilitation – not the government's share. The federal government, while technically the holder of title to most of these water projects has either operating or repayment contracts with the local entities that have the responsibility under such contracts to pay for their share of such maintenance and construction efforts. The OMB position letter does not account for this contractual relationship, leading to its erroneous accounting treatment and 100% budget scoring conclusions.

The CBO issue brief further states that “in the case of third-party financing, the government typically couples a transfer of federal property with directives on how the property may be developed.” This is not the case with P.L. 109-451 loan guarantees. There are no transfers of federally owned property nor are there government contributions or conveyances in exchange for future compensation in the Bureau's case.

The CBO issue brief also states that the source of capital for third-party financed projects is the income generated by their operation, which is usually from federal spending. The CBO issue brief goes on to state that “for most of the third-party projects carried out so far, credit assessments make it clear that the government is the only or dominant user identified in the

agreements – and hence, the only or dominate source of capital.” None of these conditions apply to the Reclamation projects or activities contemplated under P.L. 109-451.

### **The Government Does Not Have to Carry 100% of Total Loan Amount as Contingent Liability in the Federal Budget**

While the government contingent liability for these loans exists, the question becomes what is the actual contingent liability the government should carry in the budget. OMB suggests in their memo that it should be 100% of the total loan amount that is guaranteed by the government. This logic defies the entire financing system used daily by both private and public sectors alike. The government’s contingent liability should be calculated as the percentage of possible guaranteed loans that would be likely to default, taking into account the following factors:

1. The amount of collateral pledged;
2. The repayment contracts for the cost of operation and maintenance of federally-owned water supply infrastructure;
3. The leverage the Federal government holds in recovering any possible default interest and principal, and;
4. The credit-worthiness of the non-federal entity obtaining the loan.

Using this more appropriate logic, the government would only be contingently liable for a fraction of the total guaranteed loan amount – in most cases calculated to be 1%-3% of the total loan amount guaranteed. In fact, the CBO scored S. 895 (now P.L. 109-451) loan guarantees at 1% to 2% for future appropriation purposes.

### **OMB Grossly Mischaracterizes the “Comparable Economic Stake” of Local Water Districts Attempting to Secure Loan Guarantees**

The OMB memo states that the government bears the full risk of a loan guarantee because it owns the asset and benefits from the improvements made to the asset. It goes on to state that the water district (non-federal borrowing entity) relies solely on receipts generated by that asset to repay the loan, and that the water district lacks any ownership interest and does not have a “comparable economic stake” in the overall success of the project, as do water districts that own the assets. The water districts referred to in the OMB memo are either an instrumentality of the states they are located in, or are canal companies recognized as tax-exempt public-purpose organizations that share the same status as the districts. These are “public” state agencies with an enormous responsibility to operate, maintain, and replace the infrastructure that delivers water to millions acres of irrigated farms and ranches, thousands of cities, and generates countless kilowatts of electrical power used by their communities. While ownership of an asset is one means of measuring economic stake in such projects, merely holding title does not represent the vast economic and socially integrated public purposes these assets represent.

The Federal government is not the primary beneficiary of these projects. True, federal taxpayers have benefited for years from the settling of the Western U.S., for the most part accomplished through the initial construction of these projects. However, the true project beneficiaries are the non-federal public entities (and the landowner public who they serve) who have contracted with the government to repay the cost of construction, and to pay for their portion of the operation, maintenance, and replacement of these facilities. The private investment (farm and ranch development, cities and suburbs, electricity distribution facilities, etc.) that has been made over the last century that is dependent on the successful annual operation of these water projects is tremendous. One study several years ago estimated the total domestic economic product developed annually from federal irrigation projects is over \$60 billion per year (1998 dollars). Without the water and power delivered from these facilities every year to these countless beneficiaries, this vast economic engine would crumble, land values would deteriorate and many communities would cease to exist as the desert would again overtake these now-fertile areas of the arid West.

What if these facilities cease to operate due to the inability of these public non-federal agencies to obtain timely financing to cover their share of such improvements? Then, the water rights issued by the state that allow the facilities to operate would also cease, and the federal “asset” would essentially be rendered worthless – probably casting the facility into the “liability” column of the federal balance sheet. The federal “economic stake” is dwarfed by the true economic stake of the many project beneficiaries who repay or have repaid the construction and operation costs of these facilities. This fact, however, does not diminish in any way the many public benefits derived from these facilities: the Federal government does have the responsibility to pay the public’s share of these major rehabilitation costs. The flood control, fish and wildlife, and recreational benefits derived from these federal water projects have been recognized by Congress for years. On the other hand, the OMB memo diminishes the economic stake of the non-federal project beneficiaries. This is a huge error in logic when weighing the risk to the government from the guaranteed loans proposed by the Rural Water Supply Act

**Federal loan guarantees are designed to function in precisely the opposite direction that the Office of Management and Budget suggests.**

The OMB memo suggests that federal loan guarantees in this instance are equivalent to borrowing of private capital by a federal agency to finance such improvements. It suggests that use of public funds derived from the U.S. Treasury is less expensive for the taxpayer because the rates on Treasury bonds are lower than rates from the private sector. This position is likely supported by OMB’s erroneous assumption that assigns 100% risk to the federal agency guaranteeing a loan.

Federal Loan Guarantees are designed to function in precisely the opposite direction. Federal Loan Guarantees bring private capital and private sector risk to the equation --- which actually decreases or limits federal exposure. The risks to the federal government are arguably and substantially less than 100%, due to the following factors:

1. The non-federal borrower's dependence on the facility;
2. The "creditworthiness" analysis required by P.L. 109-451;
3. The economic stake of the non-federal borrower and their customers in a reliable facility (as previously outlined);
4. The contractual arrangement with the U.S. for water supply at stake; and
5. Subsequent leverage to collect any possible defaults that may arise.

The OMB analysis also ignored the fact that other authorities allowing Reclamation to provide "direct loans" require that they be "interest-free" to the borrower.

**The Federal taxpayer would benefit immensely under a loan guarantee program.**

Finally, federally authorized tax-free municipal bonds are typically used to finance public infrastructure improvements. However, given the current mortgage crisis, they are currently priced well above Treasury rates. Credit instruments guaranteed by the full faith and credit of the federal government, however, would price very close to Treasury rates. In analyzing what the most cost-effective public financing alternative to the "taxpayer", as OMB describes, the federal taxpayer would benefit immensely under a loan guarantee program, since federal tax dollars would be leveraged to obtain private financing. Further, the interest would actually be paid for by the non-federal borrower. With direct loans, given Reclamation's current authorities, the taxpayer would pay the interest (the R&B Program loans were "interest-free" to qualified borrowers).

Furthermore, the federal "subsidy" for guaranteed loans - if accounted for properly - would be significantly lower than the subsidy provided through tax-free municipal bond financing.